IT 02-0051-GIL 11/20/2002 BASE INCOME

> General Information Letter: Foreign income excluded from gross income is generally excluded from base income. Credits – Foreign Tax – General Information. No credit is allowed for taxes paid to Canada or to its provinces.

November 20, 2002

Dear:

This is in response to your letter dated August 16, 2002 in which you state the following:

> Can you please tell me the following information relating to state income tax withholding on foreign-earned income of expatriates who remain state residents while on foreign assignments:
>
> 1. Is Foreign-earned income subject to withholding in the state?
> 2. Does the state allow federal Internal Revenue Code §911 exclusions (earnings and housing) on such income?
> 3. Does state law provide a tax credit for foreign taxes paid (please specify if the state allows a credit only for taxes paid to a Canadian province)?

According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill.Adm.Code §1200, or on the website http://www.revenue.state.il.us/legalinformation/regs/part1200.

Due to the nature of your inquiry and the information presented in your letter, we are required to respond with a GIL. GILs are designed to provide background information on specific topics. GILs, however, are not binding on the Department.

> 1. Is Foreign-earned income subject to withholding in the state?

The Illinois Income Tax Act (IITA) ties this State's withholding requirements to those of the Internal Revenue Service. IITA §701(b) declares that:

Any payment, (including compensation) by a payor maintaining an office or transacting business within this State and on which withholding of tax is required under the provisions of the Internal Revenue Code shall be deemed to be compensation paid in this State by an employer to an employee for the purposes of Article 7 and Section 601(b)(1) to the extent such payment is included in the recipient's base income and not subjected to withholding by another State.

If the foreign-earned income is paid outside Illinois by an employer that does not maintain an office or transact business within Illinois, withholding is not required.

> 2. Does the state allow federal Internal Revenue Code §911 exclusions (earnings and housing) on such income?

Yes, Illinois follows and allows the exclusions or exceptions in Internal Revenue Code Section 911.

For purposes of the IITA, the computation of an individual's base income begins with taxpayers adjusted gross income. IITA §203(a)(1). Because foreign earned income of a qualified individual would be excluded from adjusted gross income pursuant to IRC Section 911, such income would effectively be excluded from Illinois income tax. There is no requirement that such foreign earned income be added back to base income.

Similarly, IRC Section 911(a)(2) allows an individual to exclude from his adjusted gross income a portion of his housing expenses incurred while living in a foreign country. Unlike the earned income exclusion, the statute does not require the taxpayer to receive foreign earned income to qualify for the foreign housing costs exclusion. Instead, the taxpayer must simply maintain a tax home (as defined in IRC Section 911(d)(3)) in a foreign country. IRC Section 911(d)(2). An Illinois taxpayer may allocate their foreign housing exclusion, in whole or in part, to Illinois if their housing expenses are attributable to income earned in this State.

3. Does state law provide a tax credit for foreign taxes paid (please specify if the state allows a credit only for taxes paid to a Canadian province)?

There is no provision in the Illinois Income Tax Act for a deduction (subtraction) from federal adjusted gross income for foreign taxes paid. If such a deduction were allowed for federal income tax purposes, such a deduction would already be reflected in the individual's federal adjusted gross income. However, Illinois allows an individual a foreign tax credit. Section 601(b)(3) of the IITA provides a credit for tax paid to another state on income also subject to Illinois income tax. This credit will not exceed that amount which bears the same ratio to the tax imposed by the Illinois Income Tax Act as the amount of taxpayer's base income subject to tax both by such other state, or states, and by this State bears to the taxpayer's total base income subject to tax by this State. The credit is not allowed if any creditable tax was deducted in determining base income. There is no foreign tax credit for income tax paid to a foreign country. The credit is only allowed for income tax paid to a state of the United States, District of Columbia, Puerto Rico, and any territory or possession of the United States, or any subdivision of any of the foregoing.

As stated above, this is a general information letter which does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Matthew S. Crain